

**MELANIE L. FEIN**  
601 PENNSYLVANIA AVENUE, N.W.  
SOUTH TOWER  
SUITE 900  
WASHINGTON, D.C. 20004

(202) 302-3874  
(703) 759-3912  
*fein@feinlawoffices.com*

*Admitted in Virginia and  
the District of Columbia*

May 16, 2011

Ms. Jennifer J. Johnson  
Secretary  
Board of Governors of the Federal Reserve System  
Washington, D.C. 20551

**Re: Docket No. R-1413; Prohibition Against Payment  
of Interest on Demand Deposits**

Dear Ms. Johnson:

This letter is filed on behalf of my client, Federated Investors, Inc., sponsor of the Federated family of mutual funds with over \$350 billion in assets under management. Federated is a leading manager of money market funds.

The Board's request for comment indicates that it perceives the potential for banking instability and other systemic risks resulting from the repeal of Regulation Q. As a major participant in the short term money markets, Federated shares the Board's concerns and believes that Board action is urgently needed to address the impending systemic risks posed by Regulation Q repeal.

It is all but certain that the abrupt repeal of Regulation Q will cause a sharp decline in bank profitability until banks find ways of generating sufficient additional revenues to cover increased funding costs resulting from the payment of interest on business checking accounts. Banks of necessity will need to increase the cost of credit to borrowers and raise fees for services to retail and commercial customers alike, with potentially damaging effects on economic growth and recovery.

Excessive competition is likely to commence not only for bank deposits but all bank products and services as banks seek to gain advantage from the disequilibrium created by Regulation Q repeal, or take defensive measures. Competition is healthy when it evolves in response to normal market conditions over time, but can be deleterious when ignited by a sudden artificial force—such as a regulatory event like Regulation Q repeal—especially when large numbers of industry participants are under economic stress.

Interest rate risk already is a major supervisory concern among the banking regulators.<sup>1</sup> Regulation Q repeal will significantly exacerbate interest rate risk and present even greater risk management challenges for banks.

Some banks will suffer a net loss of deposits due to aggressive price competition. Competition for deposits will be especially challenging for small community banks that currently excel at competition based on services and customer relationships but lack the ability of larger banks to engage in sustained rate competition. Relationship-based deposits provide community banks a stable source of funding that will be threatened by rate competition.

The total deposit base of the nation's banking system will increase as business customers shift funds from money market funds and other investments to insured, interest-bearing deposits. Yet banks currently do not have the capacity to deploy these deposits in creditworthy loans sufficient to earn a return commensurate with the anticipated increase in the cost of funds. Nor is it likely they will in the foreseeable future. The quality of bank loan portfolios could deteriorate as banks face increased pressure to lend.

Moreover, the increase in bank deposits will significantly increase the cost of deposit insurance for banks and the potential cost of bank failures to the industry, government and taxpayers. This vast expansion of the federal safety net is contrary to the intent of the Dodd-Frank Act to eliminate too-big-to-fail institutions. It will result in even larger depository institutions because of the direct increase in deposits and because price competition likely will increase merger activity as smaller banks find they cannot meet aggressive price competition from larger banks.

The increase in total bank deposits resulting from the payment of interest on business checking accounts will come largely from money market funds. These funds are highly liquid cash-management vehicles that invest in high-quality, short-term instruments and pay a market rate of return. Money market funds historically have served as an alternative to noninterest-bearing bank

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<sup>1</sup> See Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation on Oversight of Dodd-Frank Implementation: Monitoring Systemic Risk and Promoting Financial Stability before the Senate Committee on Banking, Housing, and Urban Affairs, May 12, 2011, and supervisory issuances cites therein on interest rate risk. The OCC has devoted an entire handbook to interest rate risk. See Comptroller's Handbook on Interest Rate Risk (1997-98). This guidance needs to be updated in light of Regulation Q repeal.

deposits and will remain an attractive cash-equivalent for amounts in excess of the FDIC insurance limit of \$250,000.<sup>2</sup>

The outflow of funds from money market funds, however, will harm the commercial paper market, as occurred dramatically during the 2008-09 financial crisis. Mutual funds are the largest purchasers of commercial paper, holding nearly 40 percent of the commercial paper that businesses issue to finance payrolls, inventories, and other short-term operating needs.<sup>3</sup> The liquidity of the commercial paper market is tied to the flow of funds in money market funds.

Banks cannot substitute for money market funds as purchasers of commercial paper. They cannot purchase equivalent amounts because they are subject to a capital charge against such purchases—commercial paper is weighted at 100 percent under the risk-based capital system that applies to banks. Money market funds are not subject to capital requirements because, among other things, they are not leveraged like banks, are not federally insured like banks and, unlike banks, don't have access to the Federal Reserve discount window.

Money market funds also are large purchasers of municipal securities, holding nearly two-thirds of the short-term debt that finances state and local governments and such public projects as roads, bridges, and hospitals.<sup>4</sup> Municipal entities will find fewer purchasers for their debt as a result of Regulation Q repeal and the resulting outflow of funds from money market funds to banks. Bank capital requirements similarly impede bank purchases of municipal securities.

The repeal of Regulation Q occurred without any hearings or debate by the Congress that enacted it. It was added at the last minute, as if an afterthought. The systemic and other implications of the repeal were not fully aired and considered.

In 1980, Congress took action to eliminate the Regulation Q prohibitions on the payment of interest on personal checking accounts. But it did so in a measured way, creating an interagency regulatory committee to study the issue and phase out the prohibition gradually over a six-year period. Even so, the phase-out of Regulation Q restrictions on personal checking accounts in the

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<sup>2</sup> The outflow from money market funds will be greater than the \$250,000 insurance limit would suggest, however, because of deposit allocation programs (such as CDARs) that enable depositors to spread funds among a number of banks and thereby increase the amount of deposit insurance covering their funds.

<sup>3</sup> Source: Investment Company Institute.

<sup>4</sup> Source: Investment Company Institute.

1980's resulted in deleterious interest rate competition among depository institutions, particularly thrifts, which advertised rate offerings in excess of 20 percent in some cases. This competition resulted in excessive asset growth and a ruinous mismatch of assets and liabilities, leading to the ultimate collapse of the thrift industry. The abrupt repeal of Regulation Q for business checking accounts is likely to unleash similar forces with potentially devastating results.

We commend the Board for seeking comments on the potential impact of imminent Regulation Q repeal. The Board specifically invited comment on what alternatives it could adopt to minimize the impact of Regulation Q repeal on small entities. We believe the implications go far beyond small institutions to the short-term money markets and the economy as a whole.

### **Regulatory Alternatives**

A number of regulatory alternatives are available to minimize the systemic risks presented by Regulation Q repeal, including an increase in reserve requirements, adoption of a supervisory policy statement, and an explicit charge against bank capital.

#### ***Regulation D Reserve Requirements***

The current reserve requirement on demand deposits is 10 percent. The Board has statutory authority to adjust this amount upward to as much as 14 percent for the purpose of implementing monetary policy. The Board has taken the position that maintaining banking and financial stability is a monetary policy goal. The Board could make an upward adjustment in reserve requirements in order to dampen excessive competition for deposits and thereby mitigate interest rate risk and disintermediation in the short-term money markets that could destabilize the financial markets and impede monetary policy.

#### ***Issuance of Policy Statement***

The Board also could issue a policy statement setting forth the Board's supervisory concerns and issuing guidance for heightened interest risk management by banks. The policy statement could be issued separately or with the other banking agencies to supplement earlier policy guidance on interest rate risk.<sup>5</sup>

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<sup>5</sup> See Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Joint Agency Policy Statement: Interest Rate Risk, 61 Fed. Reg. 33,166 (June 26, 1996). The policy statement "identifies the key elements

Among other things, the policy statement should note that the repeal of Regulation Q does not *require* banks to pay interest on business checking accounts but merely eliminates a legal impediment to doing so, and that safety and soundness and other supervisory concerns may prevent a bank from paying interest on such accounts. The policy statement should declare as an unsafe and unsound practice a bank's payment of interest rates on business checking accounts substantially above market rates.

The policy statement also could prohibit Federal Reserve member banks from paying interest on business checking accounts unless the bank meets certain conditions. A bank could be required to demonstrate to the satisfaction of supervisors, for example, that its profitability will not be adversely affected, that it has established a credible program for deploying the anticipated increase in deposits in a sound lending program, and that its proposed interest rates are not excessive or designed to be predatory. A bank should be required to establish a framework for quantifying and measuring interest rate risk and demonstrate a program for managing such risk. A suggested draft policy statement is attached hereto.

The Board and other agencies also should consider adopting a framework for explicitly measuring and assessing banks' interest rate exposures similar to the framework proposed in 1995 but not adopted.<sup>6</sup> Such a framework would provide a tool for more effective monitoring of interest rate risk and establish a basis for imposing increased reserve requirements and/or an explicit capital charge.

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of sound interest rate risk management and describes prudent principles and practices for each of these elements. It emphasizes the importance of adequate oversight by a bank's board of directors and senior management and of a comprehensive risk management process. The policy statement also describes the critical factors affecting the agencies' evaluation of a bank's interest rate risk when making a determination of capital adequacy." The policy statement needs to be updated in light of Regulation Q repeal.

<sup>6</sup> 60 Fed. Reg. 39,495 (August 2, 1995). The proposed supervisory framework provided measures of the change in a bank's economic value for a given change in interest rates using a supervisory model. The framework considered the results of a bank's internal model results when that model provided a measure of the change in a bank's economic value. Banks not specifically exempted from detailed interest rate risk reporting would submit new interest rate risk Call Report schedules indicating the maturity, repricing, or price sensitivity of their various on- and off-balance sheet instruments. A bank also would have the option of reporting its internal model estimates of the price sensitivity of its major portfolios and its economic value.

### ***Capital Charge***

The banking agencies are required by statute to take into account interest rate risk in their risk-based capital standards.<sup>7</sup> The agencies chose to adopt a qualitative rather than quantitative measure of interest rate risk for this purpose. The agencies should consider quantifying interest rate risk and imposing an explicit increased capital charge for institutions with heightened interest rate risk due to Regulation Q repeal.

### ***Stress Tests***

The banking agencies also should require banks to undergo stress tests before commencing the payment of interest on business checking accounts.<sup>8</sup> The stress tests should be tailored specifically to assess different levels of increased funding costs and competitive pricing models for deposits as well as other products and services affected by Regulation Q repeal.

### ***Reporting Requirements***

The Board should require banks to submit interest rate risk Call Report schedules and other reports to enable the Board and other banking agencies to monitor interest rate risk and the systemic impacts of Regulation Q repeal.

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The idea of eliminating a Depression-era regulatory restriction may have sounded appealing to members of Congress who sponsored Regulation Q repeal. But the reason for enactment of the prohibition on payment of interest on demand deposits in 1933 remains relevant in today's still weakened banking system—to avoid ruinous competition for interests rates that banks can ill-afford to pay, and the related systemic effects. It is ironic that Congress, in its efforts to promote banking stability following the worst crisis since the Great Depression, chose to repeal a law that was enacted following the Great Depression for the very purpose of promoting banking instability.

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<sup>7</sup> 12 U.S.C. 1828 note (“Section 305(b) of Pub. L. 102-242, as amended by Pub. L. 103-325, title III, Sec. 335, Sept. 23, 1994, 108 Stat. 2233, provided that: (1) In general.--Each appropriate Federal banking agency shall revise its risk-based capital standards for insured depository institutions to ensure that those standards--(A) take adequate account of--(i) interest-rate risk. . . .”

<sup>8</sup> The Board has enhanced authority to require stress tests under the Dodd-Frank Wall Street Reform and Consumer Protection Act. 12 U.S.C. § 5365(i).

Repeal of Regulation Q is fraught with unintended consequences that likely will harm not only the banking system but the financial markets and the economy as a whole. The Board should use its systemic risk authority under the Dodd-Frank Act and existing law to address this systemic threat and prevent another financial crisis from arising.

Sincerely,

*Melanie L. Fein*

Melanie L. Fein

Attachment

cc: Eugene F. Maloney, Esq.  
Executive Vice President and Corporate Counsel  
Federated Investors, Inc.

## SUGGESTED POLICY STATEMENT ON REPEAL OF REGULATION Q

This Policy Statement on Repeal of Regulation Q is issued to all member banks of the Federal Reserve System and is intended to provide policy guidance concerning potential safety and soundness and systemic risk issues of concern to the Board resulting from the repeal of Regulation Q. This guidance supplements prior guidance issued by the federal banking agencies on interest rate risk. See Board of Governors, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Joint Agency Policy Statement: Interest Rate Risk (August, 1996).

Effective July 21, 2011, the Regulation Q prohibition on payment of interest on business checking accounts will be repealed in accordance with section 627 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The imminent repeal of Regulation Q raises potential systemic and safety and soundness concerns.

Among other things, the payment of interest on business checking accounts will increase the cost of funds for banks, affecting profitability. Competition for business customers may result in increased volatility of core deposits and excessive competition deleterious to banking stability. Some banks may experience a net loss of deposits while others may see significant gains. Management of assets, liabilities, liquidity and interest rate risk may become more challenging for banks.

Banks will need to raise their revenues to cover increased interest rate costs, which could pressure banks to increase their fees for various products and services, including those offered to retail customers. An overall re-pricing of bank products and services could intensify competitive forces resulting from repeal of Regulation Q, resulting in temporary and long-term imbalances affecting bank balance sheets.

An increase in deposits and need for revenues could pressure banks to expand their lending activities at a time when loan demand from creditworthy borrowers is weak. Banks will need to deploy increased deposits in a safe and sound manner consistent with their obligations under the Community Reinvestment Act and other and regulations.

The Board is concerned that excessive interest rate competition could be harmful to overall banking stability and the safety and soundness of banks that are not in a position to compete aggressively for deposits at this time. Internet



banking and rapid communications technology make it possible for business customers to make large and unexpected deposit shifts that could be potential destabilizing.

The Board is issuing this Policy Statement to address these and other safety and soundness concerns regarding Regulation Q repeal.

As a matter of law, the Board notes that nothing in the Dodd-Frank Act or the repeal of Regulation Q requires banks to pay interest on business checking accounts. The repeal of Regulation Q merely eliminates a legal impediment to doing so. Safety and soundness and other supervisory concerns may prevent a bank from paying interest on such accounts.

The Board will closely monitor banks that pay interest on business checking accounts to ensure that bank management has fully addressed the impact on the bank's earnings, profitability, deposit to loan ratios, and allocation of deposit liabilities to product offerings. A bank should not commence paying interest on business checking accounts until the bank has demonstrated its ability to withstand different stress scenarios in stress tests approved by the Board.

A bank that commences paying interest on business checking accounts must be able to demonstrate that it has a program in place for quantifying the amount of anticipated deposit increase, the impact on the bank's balance sheet and the potential volatility of such deposits. Management will need to demonstrate heightened ability to measure and manage increased deposit liabilities and interest rate risk. Examiners will monitor the effectiveness of bank models used for this purpose.

The bank's program should include a detailed plan for deploying increased deposit liabilities without incurring excessive risk. Banks should not increase their deposit liabilities by paying interest on business checking accounts unless they can demonstrate sufficient creditworthy loan demand to justify such an increase.

The Board will consider it to be an unsafe and unsound banking practice for a bank to pay interest on business checking accounts at a rate substantially above prevailing market rates for its geographic region unless the bank can demonstrate an immediate loan demand to be met with such deposits, subject to appropriate reserves to account for deposit volatility. The Board will issue further guidance as to what amount is "substantially above" prevailing rates in various regions and what amount of reserves is considered appropriate.

The Board will require banks to report data showing the amount of interest paid on business checking accounts, the amount of increased deposits associated therewith, the impact on the bank's cost of funds, how the bank is investing or deploying increased deposits, and other information to enable the Board to evaluate the impact of Regulation Q repeal on banking stability.

The Board will closely monitor and scrutinize the payment of interest on business checking accounts by banks in order to assess the need for further supervisory guidance or regulation.